CIO *Monthly Letter*

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Spinning the Rubik's Cube

- *While markets overall have been relatively quiet in 2014, a number of areas including the government bond market, the euro, and intra-equity performance have surprised investors.*
- *This should remind us of two immutable truths in investing: be humble, and be diversified. But, perhaps, an additional 'truth' in investing is: where you have conviction, act.*
- *On a tactical basis, over the next six months, we maintain our conviction that equities will outperform bonds against a backdrop of an improving global economy.*
- *We also believe credit will outperform high grade in the fixed income space, and within currencies that the US dollar will appreciate relative to the euro.*

Do you remember the Rubik's Cube? If not, it's a compelling 3-D combination puzzle invented in 1974 by a Hungarian, and used for generations by curious people, both kids and adults.

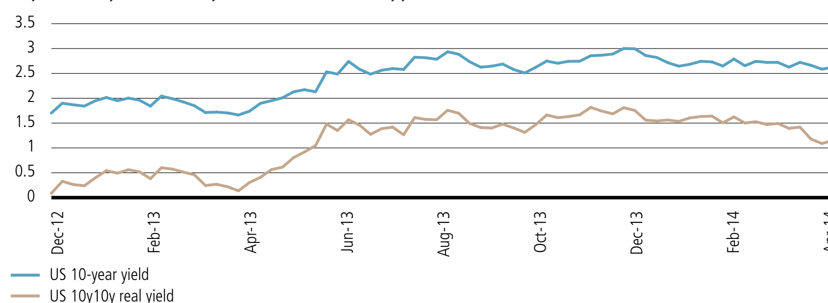
I bring up this wonderful puzzle because I think it is a useful metaphor for how to conceptualize the financial markets today. In one dimension, the markets appear driven by the regional economic news in the US, Europe, and China. In another dimension, the driver looks more like divergent central bank policy in the developed markets. In another dimension, geopolitics looks like the driver. The more we spin the cube in our hands, or our minds, the more permutations there are to explain what is happening.

Where this metaphor weakens, however, is that in the global economy, as in financial markets, there is no perfect solution – no mathematical 3-D combination that produces a final desired, and stable, result.

> *10 year Treasury yields have fallen 48bps year-to-date*

Fig. 1: US bond yields have fallen sharply year-to-date

10-year and 10-year forward 10-year inflation-indexed Treasury yields (%)



Source: Bloomberg, as of 14 May 2014

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This means that investors need to ensure they are properly diversified, with the right combination of equities, fixed rate bonds, and alternatives.

In determining our tactical asset allocation, we are left, in the spirit of the cube metaphor, needing to unpack the multi-dimensional drivers for each asset class. And so for the purposes of this letter, I think it would be useful to examine the major asset classes and consider the following: what did we think would happen when the year started, what has actually happened and why, and what do we expect will happen for the rest of the year?

Here is the summary. In the fixed income arena, we have been surprised by the strength in high-grade bonds so far this year, but hold our conviction that yields will increase against the backdrop of an improving US economy and Fed tapering. We retain a positive stance on high yield and investment grade credit, albeit reducing the size of our investment grade overweight this month to take profits. In equities, performance has been broadly in line with our expectations at a headline level, but this has masked some significant swings within sectors and countries. We retain our preference for the developed markets over the emerging markets, and for the US technology sector which is well leveraged to increasing capital expenditure. Finally, in currencies, the euro's strength has surprised, but with the ECB likely to loosen policy further at its forthcoming meeting we retain our conviction that the euro will underperform the US dollar.

> *We have been surprised by the strength in high grade bonds this year*

Bonds

What did we expect?

When we began 2014, it seemed highly likely that Treasury, Gilt, and Bund prices would fall and yields would steadily increase. The Federal Reserve was tapering its quantitative easing program, global economic growth was set to improve, and a long-awaited re-allocation away from bonds and toward equities was expected to take hold. The view, shared by us, seemed rational and was widely held.

What happened and why?

Just over five months into the year, US 10-year Treasuries yields have fallen by –48bps (see Figure 1), German 10-year Bund yields are down –54bps, and UK 10-year Gilts yields are –44bps. In short, we have been wrong so far.

> *Geopolitics and slower than anticipated US growth played roles*

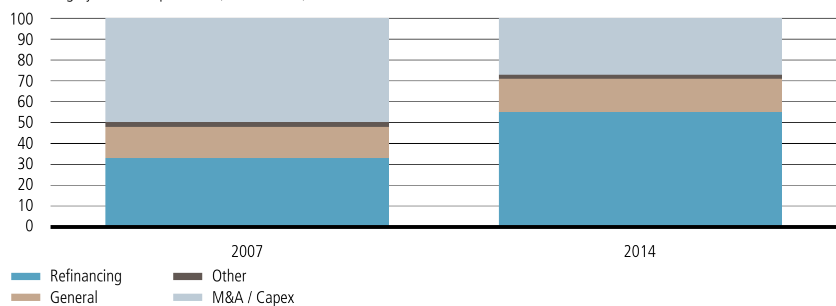
Some unforeseen factors may explain part of what has happened. The likelihood of geopolitical incident increased significantly since the year began. Despite Russian President Putin's recent attempt to deescalate the situation in Ukraine by calling on separatists to postpone a regional referendum, tensions in the country are sure to remain high in the build-up to the May 25 national election. At the same time, China is increasingly asserting is regional dominance with regards to Japan and Vietnam, implicitly testing the US' commitment to its Asian allies.

Additionally, the US economy grew more slowly than expected in the first quarter. Data released this month shows just 0.1% growth over the period. And the chance of an economic hard landing in China has increased. Growth has slowed to below 6%

> *27% of new high yield issuance has been used to fund M&A, well below 2007's 50%*

Fig. 2: High yield issuance still not for aggressive purposes

Global high yield use of proceeds (as % of total)



Source: Bloomberg, as of 14 May 2014

quarter-over-quarter annualized, and with property sales slowing we ascribe a 30% probability to a scenario where China records sub–6% growth for the full year.

But, these explanations are not fully satisfying. If global risk truly has increased this year, it would seem odd that such risks have not been priced into equity option prices, which remain close to multi-year lows. The Q1 slowdown in the US is widely attributed to weather-related effects – we expect a re-acceleration to +3.7% on an annualized basis in the second quarter. And if low rates of inflation are an explanatory factor, it would be inconsistent with the similarly sharp rally in inflation-linked government bonds.

> *Structural factors may also be at play*

We're left considering whether structural factors may be at play. A relatively benign explanation might be that non-price motivated investors, such as pension funds, are seeking to buy long-dated bonds rather than equities. Fed data shows that private pensions added more than USD 100bn in Treasuries, agency debt, and corporate bonds in the second half of 2013, while they reduced equity holdings.

A more consequential explanation could be that the market is beginning to price in the possibility that the long-run equilibrium real interest rate in the US is lower than it has been previously. Traditionally, one would expect this rate to be in line with long-term GDP growth expectations. But the market is now pricing that five years from now, real 10-year interest rates will be just 1.1% (see Figure 1).

What is our view going forward?
We would acknowledge that with significant uncertainty about the drivers of the recent rally, there is also increased uncertainty surrounding the path yields may take from here. The recent rally should highlight the value of holding a portion of fixed rate bonds within a diversified portfolio.

> *Ultimately, we retain our conviction that yields will rise as the US economy grows.*

Ultimately, we retain our conviction that yields will increase. The Federal Reserve is still tapering its quantitative easing program, we continue to expect the economic recovery in developed markets to gather pace through the year, and we believe market focus will shift toward interest rate hikes in the US and UK. Therefore, on a tactical basis we continue to recommend allocating some portion of strategic bond allocations toward equities.

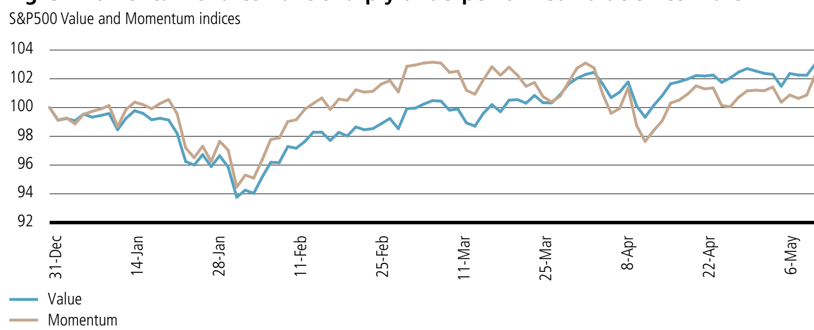
Within fixed income, we recommend US high yield credit and global investment grade credit over high grade bonds. That said, we have slightly reduced our overweight allocation to investment grade this month in order to lock in profits after strong performance. This has come about in part due to its slightly longer duration and in part due to a compression in credit spreads, which are now back to 2006–7 lows.

> *We recommend US high yield and global investment grade credit over high grade bonds*

US high yield credit remains an attractive area. The current earnings season is demonstrating 13% profit growth at US high yield issuers. We expect default rates to remain low in the aftermath of the widely expected default of Energy Future Holdings (TXU). And, while we will continue to monitor the significant recent uptick in mergers and acquisitions

> *High momentum US stocks have under-performed value by 6% since early March*

Fig. 3: Momentum shares have sharply underperformed value since March
S&P500 Value and Momentum indices



Source: Bloomberg, as of 14 May 2014

activity, issuance is largely being used for credit-friendly refinancing, rather than equity-friendly M&A or buybacks. So far this year, 27% of new issuance has been used to fund M&A, relative to 50% in 2007 (see Figure 2).

Equities

What did we expect?

After a stellar year for equities in 2013, we believed the outlook for 2014 would be for more muted, but still positive, equity performance, driven by high single digit earnings growth. We held a preference for the developed over the emerging markets, given developed markets' more stable growth picture.

> *At a headline level, equities have met our expectations this year*

What happened and why?

At a headline level, equities have met our expectations, rallying in a relatively muted fashion, with the MSCI World up 2%, and with Q1 year-over-year earnings growth tracking at +4-5% for companies in the S&P 500. But this masks some significant swings within sectors and countries, notably since March. The emerging markets and utilities entered the year out-of-favor among investors, but since March have outperformed, while the in-vogue biotech and internet sectors have suffered.

> *But this masks some significant swings within sectors and countries*

We can see this shift most markedly if we compare the performance of a basket of stocks demonstrating "momentum" to a basket of stocks with "value." (see Figure 3). Over the long haul, the old adage that "the trend is your friend" can be shown quantitatively to be true, and one should expect stocks demonstrating high momentum to outperform those with low momentum. But a rotation which began on March 6 now means that stocks demonstrating high momentum (i.e. those with strong returns over the prior six months) trade at similar valuations to those showing low momentum.

One might ordinarily expect such a sharp move to be driven by a major economic data point, policy announcement, or geopolitical event. But it appears to have happened with no catalyst. This has caught many by surprise, and is part of the reason that equity long-short hedge funds delivered performance of –0.7% in April.

The violent shift toward last year's out-of-favor markets has also meant that within the emerging markets, last year's "fragile" group of India, Indonesia, Turkey, and Brazil have performed particularly strongly. To some extent, this has also been supported by declining US bond yields, and a weak US dollar.

> *We believe the sell-off has created select opportunities within pharma, biotech, and US technology*

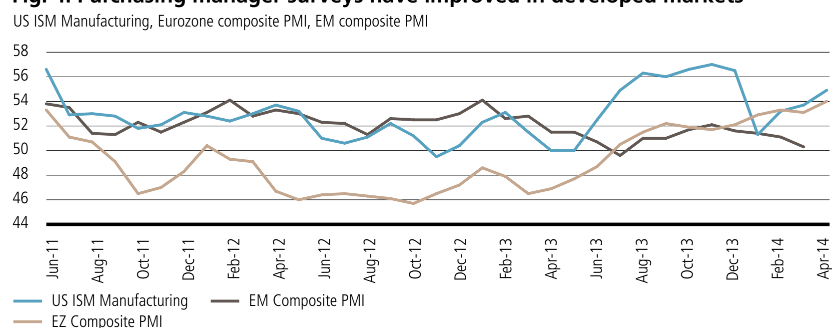
What is our view going forward?

We believe the sell-off in certain equity sectors has created a number of opportunities. In the pharmaceutical and biotech sector, for example, we would highlight a number of opportunities in cancer therapeutics, where we believe significant advances in immunotherapy represent the beginning of a new wave of therapeutics with high sales potential. And we still like the US technology sector as a whole. Sector valuations are attractive, and US technology is well positioned to benefit from a recovery in capital expenditures in the US given its 75% revenue exposure to enterprise spending.

> *US Manufacturing ISM climbed to 54.9 in April*

Fig. 4: Purchasing manager surveys have improved in developed markets

US ISM Manufacturing, Eurozone composite PMI, EM composite PMI



Source: Bloomberg, as of 14 May 2014

> *We still prefer developed market over emerging market equities*

We also still prefer the developed markets over the emerging markets. Emerging markets have not seen a major improvement in economic fundamentals (see Figure 4). Manufacturing purchasing managers' indices remain below 50 in China, Brazil, and Russia, and industrial production is still trending sideways across emerging markets as a whole. Furthermore, should the recent trends in bond yields reverse, as we expect, it would likely limit the scope for EM outperformance.

Currencies

What did we expect?

As I discussed in last month's CIO letter, with the inflation and monetary policy picture between the United States and Eurozone diverging we had expected the US dollar to strengthen over the euro.

> *Many, including us, have been surprised by the persistent strength in the euro*

What happened and why?

Similar to the government bond rally, many, including us, have been surprised by the persistent strength in the euro. EURUSD last week came within touching distance of 1.40.

Exactly what is helping the single currency defy gravity has been one of the hottest discussions I'm having with clients and with my colleagues so far this year. To some extent, the euro's strength could be attributed to the relative economic strength in the Eurozone over the weather-affected US in the first quarter. Meanwhile, the Eurozone's positive current account position ensures regular trade flows into the currency.

What is our view going forward?

We should acknowledge that with some uncertainty about the drivers of the recent currency strength, there is increased uncertainty regarding the currency's onward path. And on a *strategic* basis, we recommend that clients hedge foreign exchange risk back into their domestic currency to help insulate portfolios against unpredictable swings.

> *We still believe the drivers for our tactical underweight on the euro vs the US dollar are valid*

But, we still believe the drivers for our *tactical* underweight stance on the euro relative to the US dollar are valid, and will take effect to weaken the euro relative to the US dollar over the balance of the year. Why?

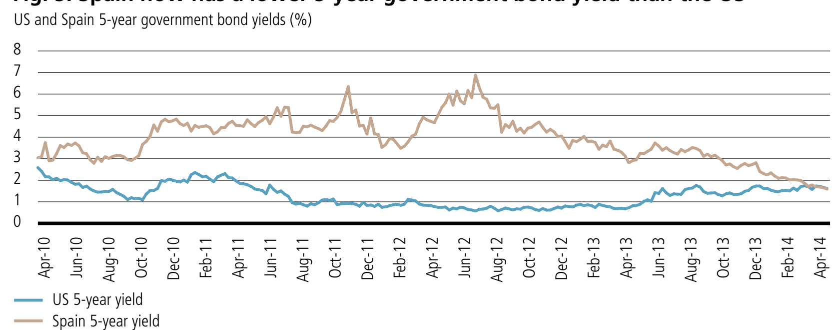
First, we expect the US economy to demonstrate relatively higher growth and momentum in the second quarter than the Eurozone. We are looking for 3.7% annualized quarter-over-quarter growth in the US, from 0.1%, and 1.2% in the Eurozone.

Second, the c.1.1% yield premium available on five-year Treasuries over Bunds should ordinarily speak for a significantly weaker euro. Part of the reason it may have failed to lure flows away from the Eurozone so far has been that foreign buyers have been enticed by the yields on offer in the European periphery. Yet with Spain's five-year bond yield now lower than that of the US (see Figure 5), the justification for investors, from a yield perspective alone, of buying government bonds in the Eurozone rather than the US is clearly diminishing.

> *Spanish 5-year government bond yields are now 2bps lower than the US*

Fig. 5: Spain now has a lower 5-year government bond yield than the US

US and Spain 5-year government bond yields (%)



Source: Bloomberg, as of 14 May 2014

Finally, and crucially, at last week's European Central Bank press conference, ECB President Draghi effectively pre-committed to cutting interest rates at the Bank's June meeting. This should underline that the central bank is concerned about the deflationary impact of a strong euro and stands ready to act. We expect a 15bps cut to both the refinancing rate and the deposit rate (to 0.1% and –0.15%, respectively) at the next meeting, cuts which are not fully priced in by the market if we look at current overnight interest rates of 18bps.

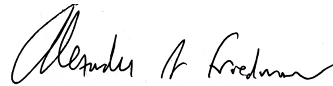
Conclusion
In summary, while markets overall have been relatively quiet in 2014, a number of areas including the government bond market, the euro, and intra-equity performance have surprised investors.

This reminds me of two immutable truths in investing: be humble, and be diversified.

But, perhaps, an additional 'truth' in investing is: where you have conviction, act. My team and I still see opportunities in the right combination of equities, fixed rate bonds, and alternatives. On a tactical basis, over the next six months, we maintain our conviction that equities will outperform bonds against a backdrop of an improving global economy, that credit will outperform high grade, and within currencies that the US dollar will appreciate relative to the euro.

Thanks for reading this letter, and for spinning the cube with me.

Sincerely,



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